Internal Revenue Service

memorandum

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Br1:JCAlbro

date: SEP 13 1988

to: Utility Industry Counsel CC:CLE

from: Director, Tax Litigation Division CC:TL

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subject: [redacted] - Qualified Progress Expenditures

This is in response to your request for technical advice dated June 16, 1988.

ISSUES

1. Whether the construction period of a nuclear plant has begun for purposes of the qualified progress expenditure (QPE) provisions of I.R.C. § 46? 0046-300

2. Whether contract retainages under these facts, qualified progress expenditures? 0046-300

3. Whether bulk materials which have not been devoted to the asset qualified progress expenditures? 0046-300

CONCLUSIONS

1. The regulations do not require that actual physical work at the site is necessary for construction to begin. The beginning construction determination is based on the facts and circumstances of each case. Further factual development is necessary to determine whether off-site physical work on a plant component or an item of property, which will comprise an integrated unit of property, will meet the requirements for the beginning of construction.

2. Contract retainages are not eligible for QPE's unless the property is self-constructed which is a factual determination in the year construction begins. Property is not self-constructed property for purposes of QPE's on the basis of the degree of taxpayer control over the details of construction by contractors.

3. Bulk materials which are neither a part of the constructed asset nor irrevocably allocated to it are not qualified progress expenditures.

FACTS

The [redacted] generating plant was to be constructed [redacted]. An engineering contract was entered into on [redacted], with the [redacted], and the contract listed a beginning construction date of [redacted], with [redacted] scheduled for commercial operation on [redacted]. Subsequent revision of the completion dates for the units projected [redacted] in service in [redacted] and [redacted] in [redacted]. In taxpayer's [redacted] financial statement further delays were noted. Taxpayer stated in its [redacted] Financial Statement that the scheduled in-service dates were revised to [redacted] and [redacted] and groundbreaking was scheduled for early [redacted].

The engineering contract called for [redacted] to prepare all documents for taxpayer to procure construction services. Taxpayer was to select vendors and issue purchase orders or authorize [redacted] to issue purchase orders. In the examination report for the [redacted] and [redacted] taxable years, the agent states that as of [redacted] a vendor list with purchase order numbers for materials and construction contracts does not include a constract for site preparation or foundation work. Furthermore, none of the major purchase order contracts had been issued. The project has been on hold since [redacted].

For the retainage payment issue (contract payments retained with respect to subcontractors), the agent has disallowed qualified progress expenditures (QPE) on such amounts. As will be discussed infra, for non-self-constructed property, QPE's are available for amounts paid (not incurred).

The taxpayer claimed QPE's on bulk material warehouse accounts. Not only is the taxpayer unable to provide a yearend inventory balance for bulk materials but is also unable to allocate costs to specific areas of the plant. Some areas of the plant do not qualify for QPE's, e.g., buildings, sewer systems, etc. In summary, some of the materials are non-qualified section 38 property. The taxpayer's record system does not indicate when bulk materials were placed in the plant area, but more importantly, expenditures are not allocated to specific plant areas.

DISCUSSION

I. Introduction

The Tax Reform Act of 1975 was passed in response to the United States economy's sharpest decline since the 1930's. An investment credit for progress payments was implemented because Congress viewed it as inequitable that an investment tax credit

was available only when property was placed in service in the case of property with a long construction period and for which payments are made during the course of construction. Therefore, the progress payment provision made the credit available to the extent progress payments were made in the case of property requiring at least two years to construct. Congress believed that the availability of the credit during the construction period of long lead time property would provide an incentive for utilities and others to undertake longer term projects. Sen. Rep. No. 94-36, 1975-1 C.B. 590.

To qualify for progress expenditure treatment the property must have a normal construction period of at least two years, which is determined on the basis of facts known at the close of the taxable year in which construction begins. The normal construction period is the time reasonably expected to be required to construct the property beginning with the date when physical work on construction commences and ending on the date the property is available to be placed in service. Eligible property is divided between self-contructed and non-self-constructed or acquired property.

If the property is self-constructed, that is, more than half the construction cost will be paid directly by the taxpayer, the amount of the QPE for a given year generally equals both direct and indirect costs incurred by the taxpayer that are properly chargeable to capital account in connection with the property.

For acquired property, the QPE equals amounts paid someone else during the year for construction but only to the extent actual progress is made in construction during the year. Work progress is computed under a percentage of completion rule.

II. Whether the Construction Period Has Begun

The threshold legal issue is whether construction has begun. The agent takes the position that the construction period must begin before QPE's may be claimed, and the normal construction period begins no earlier than when actual physical work or construction begins. Preliminary work such as site clearing or preparation, design and planning does not qualify, and the [redacted] project has not gotten beyond planning and design for the taxable years at issue. Taxpayer's response is that the construction process commences long before the actual site work begins. Furthermore, the taxpayer states that the furnish and erect contracts for major components of the plant have to be designed and in various stages of construction prior to commencing actual site work, and such contracts have been exercised. The taxpayer reasons that the costs related to such contracts are irrevocably allocated to the plant construction, and equipment once designed and constructed is an integral part of the plant, with no value extrinsic from the plant, except as scrap.

The investment credit for qualified progress expenditures is for the construction of progress expenditure property. Progress expenditure property has a normal construction period of two years or more and has a useful life of seven years or more. Whether property is progress expenditure property is determined on the basis of facts known at the close of the taxable year in which construction begins. Treas. Reg. § 1.46-5(b)-(e). Accordingly, we agree with the agent's conclusion that determining the normal construction period is necessary to determine whether the property is progress expenditure property and that determination can only be made at the close of the taxable year in which constructions begins.

QPE's are available during the normal construction period which "begins on the date physical work on construction of the property commences." Treas. Reg. § 1.46-5(e)(1)(i).1/ Physical work on construction of property does not include preliminary activities such as planning, designing, preparing blueprints, exploring or securing financing. Id. The regulations, though, provide additional standards for determining when construction commences and clarify that construction need not commence on the main site of the property to be constructed.

Treas. Reg. § 1.46-5(e)(1)(ii)&(iii) provide that the determination of when physical work on construction commences is based on the facts and circumstances of each case. Physical work on construction may include physical work done by a subcontractor on a component specifically designated as part of the property. The commencement of physical work on construction may occur at a site different from the main site of property construction. For example, if a shipyard orders a turbine before beginning work to build a ship, the ship's normal construction period is measured from the time the subcontractor commenced physical work on the turbine-assuming it is normal for such work to precede the work of the main contractor.2/

1/ See also Treas. Reg. § 1.46-5(g)(2); QPE's do not include amounts incurred before the normal construction period begins. This is consistent with legislative history which provides that progress expenditures are not to be taken into account to the extent that they occur before the start of the normal construction period. H.R. Rep. No. 19, 94th Cong., 1st Sess. 37, 39 (1975).

2/ The regulations also state that the normal construction period does not include physical activity that is not necessary to complete construction of the property. We assume this last provision was intended to exclude "busywork" - i.e. nonessential and substantively unnecessary activities.

The regulations also discuss integrated units. Treas. Reg. § 1.46-5(e)(3). An integrated unit would include a ship and its turbine or the various component parts comprising the generating plant at issue. Specifically, the regulations provide that property is part of an integrated unit only if the operation of that item is essential to the performance of the function to which the unit is assigned. Property essential to the function of the integrated unit includes property the use of which is significantly connected to that function and which effects the safe, proper, or efficient performance of the unit. Generally, property must be placed in service at the same time to be considered part of the same integrated unit.

For property that will be placed in service as an integrated unit, the taxpayer must determine the normal construction period of the integrated unit which will be measured by the beginning of the normal construction period for the first item of section 38 property that is part of the unit. The regulations also clarify that it is not necessary that physical work commence at the main construction site of the integrated unit. Therefore, the beginning construction date of a component part of the generating plant at issue which is being constructed off-site, could represent the overall beginning of the construction period for the integrated unit of the plant.

In summary, it is apparent that the agent's position that construction work has not commenced is not necessarily correct. The regulations do not require that actual physical work at the site is necessary for construction to begin. As the regulations state, the beginning construction determination is based on the facts and circumstances of each case, and thus further factual development is necessary in this case.

Physical work on a component of the plant would qualify as the beginning of construction if the component is specifically designated as part of the property. It is possible that the taxpayer is correct that construction began with one of the contracts for plant components. The generating plant also qualifies as an integrated unit. Pursuant to the integrated unit regulations, the beginning of construction for the first item of property, which is part of the integrated unit and which may be constructed off-site, represents the beginning of construction for the entire unit. Again, the commencement of construction pursuant to one of taxpayer's furnish and erect contracts may constitute the beginning of the construction period for purposes of QPE's, assuming all other aspects of the regulations are satisfied. For example, an item of property is part of an integrated unit only if the operation of that item is essential to the performance of the function of the unit.

III. Contract Retainages

Taxpayer argues that all costs qualify as QPE's because the project is self-constructed property pursuant to section 46(d)(3)(A), and the costs were capitalized. For the

self-constructed property argument taxpayer relies on Treas. Reg. § 1.48-2(b) which states property is constructed, reconstructed or erected by taxpayer if the work is done for him in accordance with his specifications. Taxpayer also cites Rev. Rul. 77-107, 1977-1 C.B. 6 and argues that the right of control is the touchstone upon which a determination of self-constructed property is predicated. Taxpayer states it has such control over the project, and it is therefore self-constructed property.

Lastly, taxpayer argues that all of the costs upon which QPE were claimed were properly chargeable to capital account in accordance with the Uniform System of Accounts prescribed by the Federal Energy Regulatory Commission, and, therefore, as amounts properly chargeable to capital account, they are QPE for the self-constructed property. Treas. Reg. § 1.46-5(d)(2)(i).

The agent's position is that the property is non-self-constructed or acquired property. Which type of property it is determines whether QPE's are available for the contract retainages. Self-constructed property expenditures are amounts paid or incurred and properly chargeable to capital account, section 46(d)(3)(A), whereas non-self-constructed property expenditures must be actually paid to another person. section 46(d)(3)(B).

Treas. Reg. § 1.46-5(K)(1) defines self-constructed property:

> Property is self-constructed property if it is reasonable to believe that more than half of the construction expenditures for the property will be made directly by the taxpayer. ... Expenditures for direct and indirect costs of construction will be treated as construction expenditures made directly by the taxpayer only to the extent that the expenditures directly benefit the construction of of the property by employees of the taxpayer. ... Construction expenditures made by the taxpayer to a contractor or manufacturer... will not be considered made directly by the taxpayer. Thus, the cost of component parts...which are purchased and merely installed or assembled by the taxpayer, will not be considered expenditures made directly by the taxpayer for construction.

Accordingly, whether property is self-constructed property is a factual determination based on a reasonable belief standard. It is the taxpayer's burden to provide sufficient documentation to establish that more than half the expenditures for property will directly benefit construction by taxpayer's employees. We do not have sufficient facts to evaluate the agent's determination in the case, but we do note that apparently taxpayer engaged in extensive outside contracting

which is inconsistent with property being self-constructed. The outside constracting is the basis for the taxpayer's major argument on this issue.3/

Taxpayer relies on Treas. Reg. § 1.48-2(b)(1) which states that property is considered as constructed, reconstructed, or erected by the taxpayer if the work is done for him in accordance with his specifications. We note, though, that the purpose of Treas. Reg. § 1.48-2 is to define new section 38 property and Treas. Reg. § 1.48-2(b) sets out special rules for determining date of acquisition, original use and basis attributable to construction, reconstruction or erection. It is Service position that sections 46(d) and 48(b) have different purposes and need not be read in pari materia. See T.D. 8183, Investment Credit for Qualified Progress Expenditures, 1988-22 I.R.B. 5.

Taxpayer cites Rev. Rul. 77-107, 1977-C.B. 6 to support its argument. In that ruling the Service announced that it would follow Lykes Bros. Steamship Co., Inc. v. United States, 513 F.2d 1342 (Ct. Cl. 1975) and Pacific Far East Line Inc. v. United States, 513 F.2d 1355 (Ct. Cl. 1975) in cases with identical factual circumstances. In both cases, the property for which the investment tax credit was claimed was held to be acquired within the meaning of section 48(b)(2) rather than constructed by the taxpayer because the taxpayer did not exercise a sufficient degree of control over the details of construction. The ruling relates only to section 48(b) and states that if a taxpayer engages a contractor to construct property and the facts and circumstances show sufficient involvement of the taxpayer in the construction, the property is considered constructed by the taxpayer for purposes of section 48(b).

Section 48(b) and the provisions for qualified progress expenditures in section 46(d) have different purposes and need not be construed together. Service position is that Congress was aware of the distinction in section 48(b) between property constructed by the taxpayer and acquired property and used different terminology to establish two different categories of progress expenditure property under section 46(d). The rules of section 46(d) for non-self-constructed property are designed to ensure that QPE's are allowed only if the taxpayer has borne

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3/ See also Treas. Reg. § 1.46-5(k)(2) which provides that the determination of whether property is self-constructed is made at the close of the taxable year in which construction begins. Once it is reasonably estimated that more than half of the expenditures will be made directly, the fact that taxpayer makes less than half directly will not affect classification as self-constructed property, and classification is not affected by a change in circumstances. However, a significant error unrelated to a change in circumstances may be evidence that the estimate was unreasonable when made.

sufficient economic detriment and to prevent manipulation of the timing of the credit. These policy concerns exist whether property is constructed by either a closely supervised contractor or an independent contractor. Therefore, Treas. Reg. § 1.46-5(k)(1) provides that expenditures for construction are made directly by the taxpayer if the taxpayer uses its own employees to construct the property. T.D. 8183, supra.

In conclusion, we disagree with taxpayer's arguments on this issue. As a final point, we note that even as to acquired property for which QPE's are available for actual payments to the extent of actual progress, the RAR indicates that taxpayer has failed to keep adequate status reports on contractors' progress.

IV. Bulk Materials

Taxpayer's position on this issue is that the bulk materials have been irrevocably allocated to the construction of self-constructed property. This argument does not apply to acquired property because there is no allocation standard for such property. QPE's are available for acquired property as actually paid to someone else for construction and only to the extent of actual progress in construction. Treas. Reg. § 1.46-5(j)(1). The agent's position is that the plant is acquired property and furthermore disallowance of the bulk material QPE's is justified due to taxpayer's poor recordkeeping and inability to quantify total inventory as well as inability to classify expenditures according to qualifying QPE property (some plant areas are non-qualified section 38 property).

Section 46(d)(4)(A) sets out special rules for applying QPE's on self-constructed property. Under that section, property which is to be a component of, or otherwise included in progress expenditure property is to be taken into account at a time not earlier than the time it is irrevocably devoted to use in the property and as if the taxpayer (at that time) had expended an amount equal to that portion of the cost of the component which is properly chargeable to capital account with respect to the property. As noted, taxpayer argues that bulk materials have been irrevocably devoted to self constructed property. Even assuming the property is self-constructed property, taxpayer's bulk material expenditures do not meet the requirements of Treas Reg. § 1.46-5(h)(3)and (4) as to the time when amounts are properly chargeable to capital account.

Treas. Reg. § 1.46-5(h)(3)(i) provides that expenditures for component parts and materials are not properly chargeable to capital account until consumed or physically attached in the construction process, but if neither consumed nor physically attached, they are chargeable to capital account if they have been irrevocably allocated to construction. Irrevocable allocation is defined in two ways. Parts and materials designed specifically for the self-constructed property are allocated at the time of manufacture of the parts and materials. Parts and materials not designed specifically for the property are

irrevocably allocated at the time of delivery to the construction site if they would be economically impractical to remove. Mere bookkeeping notations are not evidence of allocation. The taxpayer shall maintain detailed records which permit specific identification of amounts chargeable to capital account.

The RAR lists as examples of the bulk material accounts lumber, plywood, ready mix concrete, nuts and bolts and pipefittings. Accordingly, absent evidence to the contrary, we do not believe the bulk materials were designed specifically for the property. Neither is there any evidence that they would be impractical to remove after delivery.

In summary, the threshold aspect of this issue is whether the property is self-constructed or not. See discussion, Issue 2, supra. Even if the property is self-constructed, the bulk materials or construction inventory are not QPE's because they are not a part of the constructed asset and are not irrevocably allocated as defined in regulations. Furthermore, taxpayer's recordkeeping is inadequate; it is not clear when materials were placed in the plant area, or that they have been allocated to specific plant areas.

As a final point we note that the regulations do allow QPE's for partial self-construction of an item of non-self-constructed property. Under the facts at issue, though, taxpayer has not established use of the bulk materials in self-construction. This regulation should always be considered though in circumstances of partial self-construction. Treas Reg. § 1.46-5(j)(2) provides that if an item of property is non-self-constructed, but taxpayer uses its own employees to construct a portion of the property, expenditures for construction of that portion are considered made directly by the taxpayer and are QPE's for constructed property that was not self-constructed as long as other requirements are met; e.g. actual payment and expenditures are attributable to progress made in construction by taxpayer.

If you have any further questions, please contact Joyce C. Albro at 566-3521.

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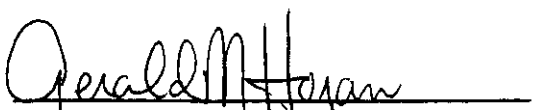
By: 

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